

Quiz B for 1:00 Class: 1/23/13

Name Key

Assume two risk-free bonds will pay \$1000 one year from today. However, the return on Bond A is 5.9% and the return on Bond B is 4.9%. What set of transactions today will generate an arbitrage profit for you today. In your answer list all transactions required today and a year from today and all individual and total cash flows today and a year from today. Use a "+" for an inflow of cash and a "-" for an outflow of cash. Note: I recommend setting up a table like is in the notes, but this is not required.

Wall Street Journal Questions are on the back of this page.

$$P_A = \frac{1000}{1.059} = 944.29$$

$$P_B = \frac{1000}{1.049} = 953.29$$

<u>Trans</u>	<u>CF₀</u>	<u>CF₁</u>	<u>Trans</u>
Buy A ⁺⁵	-944.29 ⁺⁵	+1000 ⁺⁵	Bond matures ⁺⁵
Short B ⁺⁵	+953.29 ⁺⁵	-1000 ⁺⁵	Buy back bond or make up CF ⁺⁵
<u>Total</u>	<u>+9.00</u> ⁺⁵	<u>0</u> ⁺⁵	